DIVAS EUROZONE VALUE

Monthly Report April 2022

Marketing material for professional clients

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Market environment

In April, eurozone equities oscillated within a 7% band, driven by the news flow on Russia/Ukraine, rampant inflation globally and the respective hawkish comments from central banks.

Eurozone headline inflation at 7.5% was unchanged on the previous month, while the more important, and stickier, core rate moved resolutely higher to a new record high of 3.5% from 2.9% previously. This constitutes strong evidence that rising wages are starting to rapidly feed into core inflation.

In, early April, Federal Reserve Governor Lael Brainard called the task of reducing inflation pressures paramount. “The Federal Open Market Committee will continue tightening monetary policy methodically through a series of interest rate increases and by starting to reduce the balance sheet at a rapid pace as soon as our May meeting”.

This narrative was echoed in mid-April, when Federal Reserve Bank of St. Louis President James Bullard said the central bank needs to move quickly to raise interest rates to around 3.5% this year with multiple half-point hikes and that it should not rule out rate increases of 75 basis points.

In late April, Federal Reserve Chair Jerome Powell outlined his most aggressive approach to taming inflation to date, potentially endorsing two or more half percentage-point interest-rate increases, while describing the labor market as overheated. From a similar perspective, ECB President Christine Lagarde admitted that inflation will be more than double her target at year-end.

The minutes subsequently published by the Federal Reserve officials laid out a long-awaited plan to shrink their balance sheet by more than $1 trillion a year while raising interest rates “expeditiously” to counter the hottest inflation in four decades.

According to Governing Council member Martins Kazaks the European Central Bank may raise interest rates as soon as July amid “significant” inflation risks that will probably require further tightening later in the year. He said he would not challenge trader bets that the ECB’s deposit rate - currently at a record-low -0.5% - will increase to zero this year. There is also no need for the rate to linger at this “magical number” for longer than necessary. This would be strongly earnings-enhancing for eurozone retail banks.

Following President Emmanuel Macron's re-election, the focus now is on the so-called 'Third Round', the upcoming legislative elections in June, as President Macron needs a parliamentary majority to implement both his domestic agenda and his foreign policy objectives. Considering the distribution of votes across parties and President Macron's performance on April 24, history points to a decent likelihood that the President's party will obtain a majority in the French Assembly.

According to one of the world’s biggest shipping companies, port bottlenecks that have increased supply-chain congestion because of the war in Ukraine and lockdowns in China may be showing signs of easing. Currently, the number of ships waiting outside of the ports in Los Angeles and Long Beach have been reduced to less than 40, from more than one hundred earlier this year. Should that trend continue, we can look forward to a smooth second half, with plenty of pent-up demand released, thus fuelling global economic growth.

In April, 5-year forward inflation expectations continued to drive higher, spiking 22 basis points to 2.43%. This compares to current inflation of 7.5%.

The 10-year Bund yield jumped 39 basis points to +0.94%. A step closer to a more normalised rate of +1.5%-2.5%.

The Swiss franc depreciated 0.48% to 1.0262.

In April, Brent crude oil rose 4%, while nickel and iron ore declined by 1% and 8% respectively.

The April Eurozone Composite PMI reaccelerated to 55.8 (from 54.9 previously) compared to market expectations of a decline to 53.9. The April China Manufacturing PMI slowed to 47.4 from 49.5 previously on incremental Covid lock-down measures implemented in April. The April US ISM Manufacturing PMI slowed to 55.4 from 57.1 previously.

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Performance

In April, the MSCI EMU Index declined 1.95%. The fund's euro I-shares depreciated by 1.23%, outperforming the MSCI EMU Index (net dividends reinvested) by 72 basis points. Year-to-date the fund rose 0.76%, while the market tanked 10.95%, thus outperforming the benchmark by 11.71%.

Performance contributors

- Banco BPM outperformed the market by 24% as Crédit Agricole, which has a long-standing distribution agreement with Banco BPM, made a bid for the company's insurance business.
- ABN AMRO Bank outperformed the market by 12%, benefitting from positive earnings revisions from analysts.
- HeidelbergCement outperformed the market by 10%, as worries of rising energy costs started to subside.
- Mercedes-Benz outperformed the market by 8%, on reporting a very strong set of Q1 result, beating analyst expectations by 20%, with Mercedes Cars achieving an exceptionally strong operating margin of 16.4% compared to market expectations of 14.5%. This was driven by a positive volume/price mix, more than offsetting higher industrial costs (50% raw materials).
- Aegon outperformed the market by 6%, benefitting from rising interest rates.

Performance detractors

- Despite reporting Q1 results ahead of market expectations, Banco Santander underperformed the market by 5% on profit taking, following a very strong run year-to-date.
- Despite reporting a strong set of Q1 results, Randstad underperformed the market by 4%, as the market priced in stagflation.
- Despite positively pre-announcing Q1 results, demonstrating their ability to pass on rising input costs, Lanxess underperformed the market by 4%, on worries that rising gas prices might hurt its margins.

Positioning

The fund switched its positions in Bayer and Enel, having outperformed the market since purchase by 24 and 4% respectively, into BMW and Philips. Furthermore, it reduced its positions in Aegon and Banco BPM, having outperformed the market by 8% and 48% respectively, to increase its holdings in Lanxess and Banco Santander.

Outlook

According to Bloomberg NEF, a partial drop in Russian gas flows would not derail the European market. Europe's gas storage could reach 73.2 billion cubic meters (Bcm) by the end of summer, assuming a reduced 28.8 billion Bcm of net imports from Russia from May through September. Without any Russian gas, Europe would struggle to build sufficient inventories fast enough in preparation for next winter.

Equities offering a hedge against rising inflation are extremely undervalued. Despite major concerns around inflation, valuations of such stocks do not appear to reflect such anxiety. More specifically, those companies that benefit from rising inflation are trading at a steep discount relative to their peers who benefit from falling prices, despite enjoying substantially faster-than-expected earnings growth (13.1% versus 8.0%).

Over the last decade, the valuation gap between rising inflation beneficiaries and declining inflation beneficiaries oscillated between 1 standard deviation expensive to 1 standard deviation cheap. On the back of the Russian/Ukraine crisis this measure, over the last 2 ½ months, has moved to 2 standard deviations cheap a very extreme level, we have not seen in 20 years. Since inflation beneficiaries mainly consist of banks and commodity related cyclicals, this move reflects the fact that the value factor on the back of this war is currently exceptionally attractively valued. This was driven by record outflows experienced in eurozone equities since the outbreak of the war. US investors, who only buy/sell financials and cyclicals when they engage or disengage in/from eurozone equities, have completely deserted eurozone equities over the last 10 weeks.

This could be a perfect time to engage in eurozone value stocks, since that money will return as soon as a satisfactory agreement is reached, or the market simply loses interest in the topic, thus strongly supporting the value factor.

Gaining exposure to our strategy today provides access to a portfolio, growing its earnings in the low teens for the next three years, valued on 7.6x earnings and paying a rich and growing dividend yield of 4.6%.

NAV: EUR 133.09
ISIN I shares: LU1975716835
Valor I shares: 47229643

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Equity: Investments in equities may be subject to significant fluctuations in value.

Capital at risk: All financial investments involve an element of risk. Therefore, the value of the investment and the income thereof will vary and the initial investment amount cannot be guaranteed.

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